Internal Revenue Service

memorandum

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Br.1:L.Grogan

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to: Paul G. Topolka, Special Litigation Assistant
District Counsel - Greensboro

from: Chief, Branch No. 1
Office of Associate Chief Counsel (International)

subject: [redacted] Cost Sharing Arrangement, FYE [redacted] and [redacted]

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This is in response to your request for a review of the [redacted] cost sharing arrangement in order to determine if it is a "bona fide cost sharing arrangement" within the meaning of Treas. Reg. 1.482-2(d)(4). In particular, you would like an opinion with regard to whether the results of the [redacted] arrangement comport with the changes to I.R.C. Section 482 made by Congress in 1986, and with the Treasury Department's White Paper on Intercompany Pricing, published in October, 1988.

Facts

[redacted], an American [redacted] company, entered into a written cost sharing arrangement with its [redacted] parent, [redacted], in [redacted]. The arrangement provided that each party would share with the other any intellectual property developed under their separate research and development programs, royalty-free. Research costs would be borne by the party performing the research.

In [redacted], the arrangement was considerably amplified as a result of the addition of the "commensurate with income" standard to I.R.C. Section 482. The sentence added to the Code read: "In the case of any transfer (or license) of intangible property . . ., the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." While the parties believed that their prior arrangement was in accord with the

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commensurate with income standard, they thought it necessary to record their agreement in greater detail. Costs were actually shared and benefits received for several years prior to [redacted], including the years in question, in accordance with the procedures formalized in [redacted].

Under the [redacted] arrangement, costs were to be shared each year on the basis of each party's profits for the year. The agreement provided that:

> Each party shall be required to make its Contribution regardless of whether any Developed Technology is actually produced under this Agreement, and regardless of whether the Developed Technology that may be produced proves of sufficient use or value to allow the Party to recover the cost of its Contributions. Agreement, Article 3, Section 3.1.

The definition of "Developed Technology" was any intellectual property of substantial direct benefit to both parties. The definition of "profits" was profit before taxation, determined without regard to internal or external interest payable or receivable, and without regard to certain other amounts established by [redacted].

According to the information provided, the results of the arrangement were as intended; that is, costs were divided between the parties in proportion to their profits. [redacted] percent of the costs of developing the drug [redacted], for example, were borne by the U.S. affiliate, which received [redacted] percent of the [redacted] profits.

Discussion

The legislative history to the 1986 Act noted:

> In order for cost-sharing arrangements to produce results consistent with changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally be proportionate to profit as determined before research and development.

This language was added in order to prevent taxpayers from avoiding the commensurate with income standard by using cost sharing arrangements to transfer intangible property at a less than arm's length rate. Suppose, for instance, that related manufacturers FS and USA made electrical products X and Y, and they entered into a cost sharing arrangement for the development of a new computer chip to use in those products.

Product X cost $1 and product Y cost $1. FS sold product X and USA sold product Y. The products were sold in equal amounts, and costs were evenly shared on the basis of sales of the products. Upon development, the computer chip added 100% to the value of product X and 10% to the value of product Y (without a material change in the manufacturing cost of either product). Therefore, FS received a disproportionately large share of the profit attributable to the research and development in the computer chip. USA's income would not be commensurate with the income attributable to its share of the intangible, and, if that result were foreseeable, the cost sharing arrangement might be considered in bad faith. Therefore, cost sharing arrangement participants should share costs on a reasonable basis, approximately in proportion to the profits (that is, benefits) that each expects to receive.

The [redacted] arrangement appears to have produced results consistent with the commensurate with income standard, inasmuch as the participants shared costs on the basis of profits. If profits were significantly inflated or deflated (e.g., through leveraging), it might be appropriate to use some other method to measure the benefit received by each party (for instance, measurement of each participant's gross margin). However, the [redacted] arrangement carefully defines profits to exclude items such as internal or external interest paid or received, and the method of accounting for profit seems to reflect economic reality. The use of profits as a method of measuring each participant's benefits will generally produce results consistent with the goal of the 1986 changes to section 482.

Two hypothetical cost sharing arrangements were mentioned in your letter as examples of arrangements that might not be considered in good faith. In the first, the costs of developing a drug were to be shared among the members of a related group based on the profit to be received by each participant from sales of the drug. However, the only participant that would receive any profit from the drug would be the U.S. affiliate, since the drug would be distributed at cost, for charitable purposes, in the rest of the world. You questioned whether such a result would be acceptable under the regulations.

If an affiliate will not use intellectual property developed in a cost sharing arrangement in the active conduct of its trade or business, the affiliate generally should not be participating in the cost sharing arrangement. The § 482 arm's length standard and I.R.C. Section 367(d) dictate that intangible property not be transferred from one related party to another without charge. Therefore, unless an affiliate may expect to receive more than a de minimis profit from the results of a cost sharing arrangement, the affiliate should not be a cost sharing arrangement participant. This de minimis policy does not conflict with the rule that dividing costs in proportion to expected profits is generally acceptable.

However, if more than a de minimis profit is received, but costs shared are substantially disproportionate to benefits, the cost sharing arrangement may be considered in bad faith. For instance, if the hypothetical affiliate were to sell the drug for an artificially low price in the U.S., it would be necessary to determine whether costs shared were commensurate with the benefit received.

The second hypothetical mentioned in your letter involves the same facts as the first, except that profits are not received by the other affiliates because of foreign laws regulating the price of drugs. The same rationale applies: if the affiliates receive only a de minimis benefit from the development of the intangible property, they should not be cost sharing arrangement participants. If the profit that the affiliates receive is sufficient evidence of the active use of the intangible property, however, a division of costs in proportion to profit is appropriate. Although the U.S. affiliate may bear most of the cost of developing the drug, it will also be receiving most of the income. At arm's length, the right to use such intangible property in an unregulated market would be more valuable than the right to use the property in restrictive foreign markets. Thus, although it may appear that the U.S. is subsidizing the foreign users of the drug, the U.S. affiliate will be receiving an arm's length return on its investment in the intangible property. The U.S. can combat limits on the prices of U.S. products in foreign markets by imposing limits on the prices of foreign products in U.S. markets; however, that is a matter for trade regulators, not tax administrators.

Conclusion

It appears that the [redacted] cost sharing arrangement divides costs among participants in an appropriate manner, assuming that standard accounting conventions are followed, and that there is consistency in accounting methods between the U.S. and foreign affiliates. If the scope of the arrangement is appropriate, and if the arrangement meets the other requirements described in the White Paper, the arrangement should be considered a bona fide cost sharing arrangement.

If you have any questions with regard to the above, please call Lisa Grogan at FTS 287-4851.

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